

ARIZONA DEPARTMENT OF REVENUE

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ARIZONA INDIVIDUAL INCOME TAX RULING ITR 02-2

(Supersedes Arizona Income Tax Ruling No. 84-10-5)

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

ISSUE:

Are distributions received by a taxpayer from a regulated investment company subject to Arizona income tax when such distributions are derived from U.S. Government obligations?

APPLICABLE LAW:

Various United States Code (U.S.C.) sections prohibit state taxation of income from certain obligations of United States Government sponsored enterprises and agencies and from certain obligations of United States Territories. (See ITR 02-1 Appendix for specific code sections.)

31 U.S.C. § 3124(a) prohibits all states from imposing an income tax on interest income from direct obligations of the United States Government.

Arizona Revised Statutes (A.R.S) § 43-961(5) disallows deductions when such deductions are allocable to a class of income that is not required to be included in the taxpayer's Arizona adjusted gross income or Arizona taxable income.

A.R.S. § 43-1022(6) provides a subtraction from Arizona gross income of interest income received on obligations of the United States. The amount subtracted must be reduced by any interest on indebtedness, or other related expenses, incurred to purchase or carry such obligations and deducted in arriving at Arizona gross income.

LEGAL REFERENCES:

Smith v. Davis, 323 U.S. 111, 65 S.Ct. 157 (1944), held that the intent of Congress in establishing laws to exempt its own obligations was "to prevent taxes which diminish in

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the slightest degree the market value or the investment attractiveness of obligations issued by the United States."

Nebraska Department of Revenue v. Loewenstein, 513 U.S. 123, 115 S.Ct. 557 (1994), held that 31 U.S.C. § 3124(a) does not prohibit states from taxing interest income derived from repurchase agreements involving United States Government obligations.

DISCUSSION:

Federal law prohibits all states from imposing an income tax on the interest income from direct obligations of the United States Government. Additionally, federal law may prohibit state taxation of interest income from the obligations of government-sponsored enterprises and agencies and from the obligations of U.S. Territories.

There is no distinction between Arizona's tax treatment of interest received by a direct investor as compared with a regulated investment company (mutual fund) shareholder. Regulated investment company distributions derived from interest that is exempt from state taxation by federal law may be subtracted from Arizona gross income. **See Arizona Individual Income Tax Ruling ITR 02-1 Appendix for a listing of exempt obligations for which an interest subtraction is allowed.**

RULING:

When a mutual fund invests exclusively in obligations that are exempt from state taxation by federal law, the amount of the distribution received from the fund may be subtracted from Arizona gross income.

Interest or other related expenses incurred to purchase or carry the mutual fund shares cannot be deducted. If such expenses are included in a taxpayer's Arizona gross income, the subtraction of the distribution must be reduced by the amount of the expenses. If the taxpayer itemizes deductions on his or her Arizona return, the expenses must be excluded from the taxpayer's Arizona itemized deductions.

If a mutual fund invests in both exempt and non-exempt obligations, the amount represented by the percentage of the distribution that the mutual fund identifies as exempt income may be subtracted from Arizona gross income.

Interest or other related expenses incurred to purchase or carry the mutual fund shares cannot be deducted to the extent that the mutual fund distribution is comprised of interest from tax exempt obligations.

Any gain recognized for federal income tax purposes on the sale of shares of a mutual fund containing tax exempt obligations is subject to Arizona income tax.

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Interest income earned by mutual funds through investments in repurchase agreements (repos) involving U.S. Government obligations is not tax-exempt interest derived from U.S. Government obligations and is subject to Arizona income tax.

Mark W. Killian, Director

Signed: January 17, 2002

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.